

Newsletter

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LETTER FROM ERIC...

Good planning and awareness is the theme of this newsletter. I discuss three seemingly separate matters but all of them concern a common thread: running an efficient business and avoiding costly pitfalls.

A well run business needs a way for owners to make decisions and resolve disagreements between themselves. A corporation provides just such a structure, along with other potential benefits. The principals of a corporation never have to be in doubt as to where they stand with each other or how to resolve disputes.

A business that has a good plan and is well advised will not take money from unsuitable investors. Such investors should not be a part of the equity structure of a business and can a serious liability.

A serious and professionally managed business will have a strong policy against sexual harassment and a means for dealing with it. This is not only legally mandated but common sense. Unprofessional behavior simply should not be tolerated.

Sincerely,

Eric D. Morton

SHOULD I INCORPORATE?

One of the most common questions business owners ask me is whether or not they should incorporate their business. And while every business situation has unique considerations, there are three major considerations that determine the answer: liability, taxes and business structure. Most of what I will say also applies to limited liability companies (LLCs).

First of all, let's set the record straight about who is incorporating. **If a business already exists**, the owners sell the business to a corporation they create. They receive shares of stock in the corporation as consideration for the sale. The corporation then operates a business owned by the shareholders. The owners usually become the directors and officers of the corporation so that they can run the business. **For a startup business**, the owners create a corporation first and then create a business through the corporation.

One advantage of running a business through a corporation is the liability shield the corporation provides for its owners. The owners of a corporation cannot be sued for the liabilities of the corporation, including contractual obligations and liability from the negligence of employees or persons acting on behalf of the corporation. For instance, a sole proprietor business owner can be sued if an employee causes a traffic accident while driving

for business purposes. If the employee is working for a corporation instead, the *corporation* is liable for the negligence of the employee. If a corporation enters into a contract with a vendor and subsequently cannot pay, the *corporation* will be sued for breach of contract and not the owners. A corporation's shield can only be ignored if the owners of the corporation abuse the corporation by not respecting it as a separate entity.

Of course, businesses often carry insurance to cover various areas of liability exposure, such as automobile insurance. So it may not be necessary to incorporate to provide a shield from those insured exposures. However, any business that has large and uninsured potential liabilities, particularly contractual liabilities, should seriously consider incorporating.

Taxes are another reason for incorporating. Sole proprietors pay large amounts of self-employment tax; a sole proprietor who incorporates can become an employee of the corporation and draw a salary, thereby avoiding self-employment taxes. There are

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other tax advantages with running a business through a corporation. Your accountant can advise you on the tax implications of owning a corporation and other considerations like whether to create a S corporation.

Even though incorporating a business can have significant benefits from a liability and tax standpoint, I still believe that the biggest advantage is the *structure* a corporation creates. It's the structure you set up that has the greatest impact on the success of a corporation, both in terms of the business success and the success of the relationships between business partners. If two or more people are entering into business together, and they are not married, I invariably advise them to incorporate. A corporation will formalize the business relationship in a way that lets owners be more effective at running their business and avoiding conflicts that will detract from the business objectives. The discussions and negotiations that take place when creating a corporation help owners understand each other's expectations and desires.

When a small business incorporates, the owners are must sit down and discuss who will be the shareholders and how much of the corporation each will own. They have to determine the value of the business and designate someone to perform each role in the corporation. When small business owners come to me, we go over such issues as what happens if one of the owners dies or quits working in the business. We prepare shareholders agreements and employment agreements between the parties

If two or more unmarried persons own a business together and they do not have any other type of business entity, then they are a general partnership. If one of them dies or decides to quit the partnership, then the partnership and the business are dissolved. One of the good things about a corporation is that it does not terminate when an owner (a shareholder) dies or quits working for it. The corporation continues doing

business. If the owners have worked out the appropriate agreements beforehand, the business can continue on without interruption.

A corporation provides an excellent platform to operate a business. The owners of the corporation are the shareholders. The shareholders elect the directors of the corporation. The directors set the policies for the corporation and appoint the officers who run the day-to-day operations. All corporations, large and small, have the same fundamental structure.

If a small business has more than two shareholders. I find that a corporate structure is key to avoiding disputes between owners, particularly if some shareholders are not directly involved in the day-to-day activities of the corporation. Since a corporation can hold periodic meetings of the Board of Directors to review the corporation's business plan and financial status, shareholders who do not have an active role in operations can sit on the Board of Directors, so they stay informed of the corporation's status and finances. This process prevents surprises and misunderstandings between shareholders and provides a formal means of making decisions.

I have seen corporations in which owners have had strong personality conflicts and disagreements, yet because the owners had common business interests, the corporation continued to operate profitably when the Board of Directors held regular meetings.

If a small business wishes to attract investors, the business will invariably incorporate. No one will invest in a partnership or sole proprietorship.

On the other hand, there may be valid reasons *not* to incorporate, or to wait. Since there's a cost to forming and maintaining a corporation, the first step is to evaluate whether the business and the owners can really benefit from the formal structure of a corporation. Ultimately, it's an individual decision. But I usually recommend that a

business incorporate whenever it has two or more unmarried partners. We can then create a platform for success.

BE WARY OF INVESTORS

Occasionally, small or start up business owners tell me that they know someone who wants to invest in their business. Often, the potential investor is a family member, friend, church member, or neighbor. The desire to invest usually comes from casual conversation between the owner and potential investor and often, it's the prospective investor's idea. The owner and the investor either want the investor to have a small equity stake in they business or to loan the business money.

While it may come as a surprise, I almost always advise against these investments, which are usually illegal, and always deserve close scrutiny. The state and federal laws governing business investments have strict criteria designed to protect investors from losing their money in high risk investments. Furthermore, it is not a good business idea to have such investments in a small business, for reasons described below. My discussion applies to a partnership, limited liability company or a corporation.

Why are such investments illegal? The first thing to remember is that partnership interests, shares of stock in corporations and membership interests in limited liability companies are all classified as *securities* under corporate law. Under state and Federal law, securities must be *qualified* in order to be issued to the general public. For example, all stock in a publicly traded company has been qualified for sale. The qualification process is long and complex. For a public company, this qualification culminates in an Initial Public Offering (IPO) through which the corporation's securities are first offered for sale.

If a security is not qualified, it cannot be lawfully issued unless it comes under an exception to the qualification requirement. There are numerous exceptions that might apply to a given situation. But generally speaking, the law focuses on whether or not the investor can make a prudent decision to buy the security. The investor must 1) have an existing connection to the business, 2) have a close, long term relationship with a principal of the business or, 3) be a "sophisticated investor." Sophisticated investors are institutional investors or wealthy persons with significant investment experience. (Other exceptions not discussed in this article concern the amount of money invested and the number of investors.)

The founders and principals of a business will always be able to buy their own companies' securities. Key employees and spouses of founders will usually be able to purchase. Other persons will probably not meet the exception criteria unless they have enough knowledge of the business and its principals to make a sound business decision to invest. The exceptions rarely apply to friends and neighbors, so it is illegal to give them stock or a partnership interest.

Even if a potential investor might fall under an exception, there are other pitfalls. Investors must make an informed decision and even the most sophisticated investor must have enough information to make that decision. Therefore, potential investors who are not involved with the business' plans and operations will need a great deal of information to make an informed decision. And if an investor does not have enough information, the investor can easily sue for fraud. The investor simply claims: "You didn't tell me!" And the investor is right. The burden is on the business owner to provide all material information that might affect the investment.

For business reasons, I also advise my clients to refrain from giving small equity positions in their business to a

small investor, since this can lead to troublesome disputes. The majority owners have a fiduciary duty to the minority owners. They must keep them abreast of all developments in the company, share profits, and consider them in important business decisions. A small minority owner may also believe that his or her share of ownership will not be diluted and claim that the majority owners are breaching their fiduciary duty by issuing more stock. Giving two percent of the stock in your corporation to that really good graphic artist when you are just starting out can be disastrous. If corporations plan to have minority owners, they are well served by exercising considerable foresight and understanding before proceeding.

Finally, business owners sometimes ask if they can just give an investor a promissory note in exchange for money. However, a promissory note is considered a security under California law and comes under many of the same standards and restrictions as shares of stock in a corporation. Small businesses and startups are high risk investments and the law strongly discourages casual investment in them. My experience is that those laws also protect business principals from mistakenly allowing unsuitable investors into their business.

SEXUAL HARASSMENT

Sexual harassment laws are in the news again this year. As of January 1, 2005, all employers who have more than 50 employees must provide training for their supervisors about sexual harassment. I urge business owners to provide their supervisors with such training regardless of their size. Sexual harassment is something that can tear a business apart and cost it considerable money.

While I don't specialize in labor law, I can pass on a few salient points about sexual harassment that all business owners should understand. First and

foremost, all employers--regardless of size-- must have a policy regarding the prevention and handling of sexual harassment.

Strict Liability is California Law. In California, an employer is strictly liable if a supervisor sexually harasses an employee, even if the employer did not know of the supervisor's harassment. This is different from Federal law and from the law in most other states. It is also why business owners should be proactive in prevention.

There only defense in California is where 1) an employer had a system for handling complaints of harassment, 2) the system could have prevented the harm done to the harassed employee, and 3) the employee does not use the system, then the employer may be able to avoid responsibility. Therefore, it's important to not only have a policy in place but also a system for handling complaints.

Sexual harassment claims can be very expensive. If a sexual harassment case goes to trial and the jury finds against the employer, the employer can be required to pay the employee's attorneys fees and costs, regardless of the award amount. I know of a case in which a jury awarded three female employees \$10,100.00 for sexual harassment, what might be called a sympathy award by the jury. But *after* the jury made the award, the judge presiding over the case awarded the employees more than \$53,000.00 for attorney's fees and costs!

Beyond the legal ramifications and standards for this issue, I believe that any discussion on sexual harassment should include the fact that sexual harassment is an area in which the divide between the genders becomes acute. Most sexual harassment cases come as a complete surprise to the individuals or businesses who are sued. One reason, I believe, is that many businesses have an unspoken "strong male" culture and this culture can create a blindness to these very real labor issues.

In most sexual harassment cases, the plaintiff is a woman with a harassment claim against a male supervisor. While occasionally a male supervisor truly intends to take advantage of a female subordinate, it's more often a supervisor acting in a way he might agree is a "off-color" but not really wrong or damaging. Other men in the company probably agree and would venture to say the conduct might be vulgar or unprofessional but not harassing. In the jury trial I mentioned above, the jury was split along gender lines on whether the supervisor's conduct was actually harassment. However, by luck of the jury pool draw, the jury was overwhelmingly female and the plaintiff prevailed.

So remember that men and women often have different attitudes and viewpoints on what constitutes sexual harassment. It's likely that if you take a random group of men and women and survey them individually on how they feel about the seriousness of sexual harassment, you would find overwhelmingly that the women take sexual harassment more seriously

than the men, even though they might have many other views in common.

I believe this comes in part from the greater awareness of physical vulnerability that many women feel. Without that experience, it's easy for men to overlook or misunderstand the impact of what they do. So it behooves men in managerial positions to consider that the gender perspectives on what constitutes sexual harassment run much deeper than you might think. And that this is really the basis for many of our sexual harassment laws.

In a broader sense, an anti-sexual harassment policy is a good business practice. Businesses can't afford to have a workplace where employees don't feel respected. I strongly advise my clients to ensure that they are in compliance with the appropriate standards for anti-sexual harassment policies and procedures. A single sexual harassment claim can be enormously expensive. Ignoring this important area of management can be disastrous.



ABOUT THE NEWSLETTER...

The *NEWSLETTER* is published in Carlsbad, California. We welcome your suggestions for future issues. If you would like to be removed or added to our mailing list, please let us know.

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